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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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THE MARKET More than three months have elapsed since the July lows (at K); almost a month has passed since the September lows (at W). Throughout most of the period since July, international news has been unfavorable, market psychology has been cautious to bearish (witness the 160,000 increase in the total short position on the N. Y. Exchange and the return of the odd-lot public to the selling side), and the mass of stocks has drifted rather aimlessly in either direction (mostly down). In the face of all this, the D-J Industrial and Rails Averages acted considerably better than might have been expected (and certainly a good deal better than the general market). The two indicators traced ascending bottoms at K and W (see chart). In September Industrial rose to an all-time high at P (725.53); in October Rails rallied to a primary peak at Z (152.92).

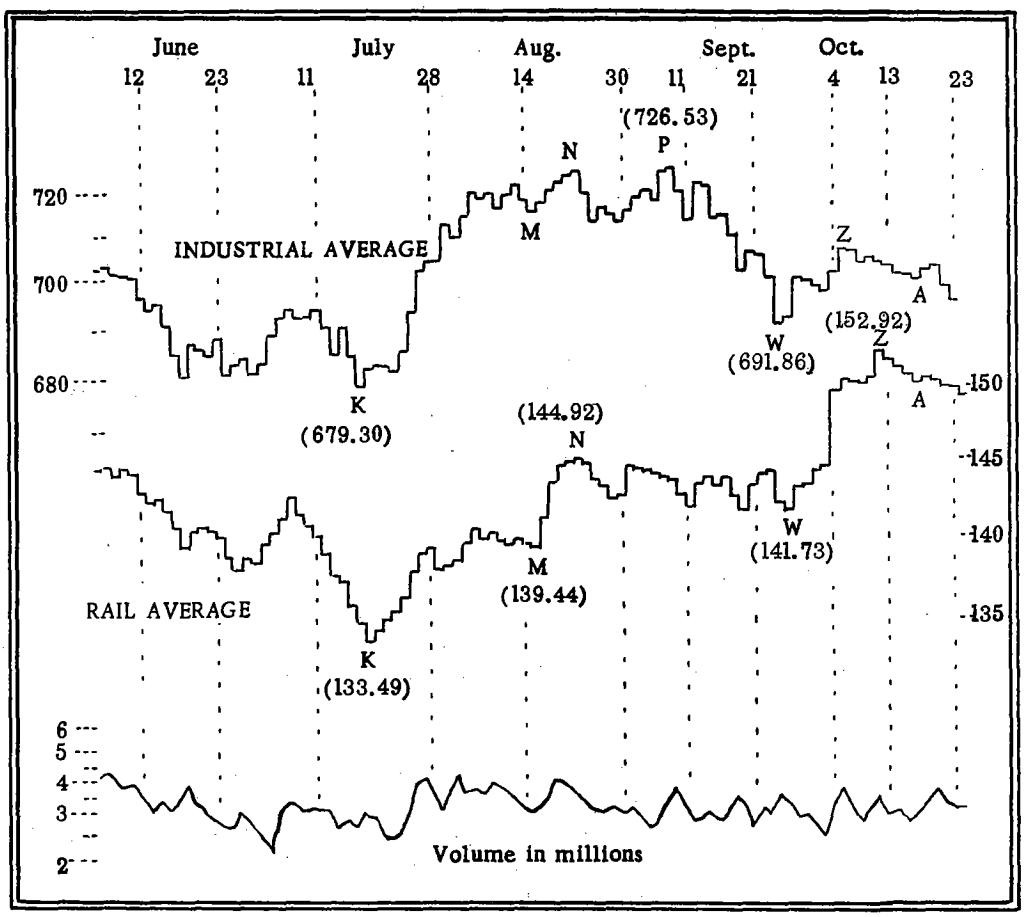
On October 10, Rails bettered their previous March 22 peak (see Letter 159), thereby (1) confirming the earlier Industrial high, and (2) reconfirming the primary bull trend. Letter 159 noted, however, that because seven weeks had elapsed between the Industrial high and the Rail confirmation, the confirmation should be considered as hopeful but not impressive (the really impressive confirmation occur simultaneously or at least a few days apart).

Following the high at Z, Rails backed off grudgingly, and on Friday (October 20) Rails formed a tiny downward zig-zag. On Monday Industrials broke sharply below their minor decline level at A, thus putting the market in position to "test" the recent lows.

Should the decline continue, the strength or weakness of the market will be tested by the ability of one or both Averages to hold above the W lows (see chart). A persistent refusal by one or both Averages to penetrate those levels will suggest that the market is stronger than would appear on the surface.

Because the Rail spurt from W to Z advanced that Average a remarkable 11 points in 10 trading days, it would now be normal to see the carriers correct the move. In that case, the Rail Average could retrace at least 1/3 to 1/2 of the W-Z rally (taking them back to the 147-49 area). If Industrial hold above W (691.86) on such a decline and volume contracts, the decline will not be without bullish implications.

CONCLUSION: The primary trend is taken to remain bullish. As long as Industrials hold above W (691.86) and Rails hold above W (141.73) the secondary trend will be bullish. The advance-decline ratio is still holding well above its July low (see Letter 155). It is my opinion (expressed many times before), however, that the A-D ratio sustained such severe damage during the decline from its May high to its July low that the odds do not favor the majority of stocks' bettering (or even approaching) their 1961



 peaks again (regardless of what the Averages do). This means that (1) a great many stocks and groups have "topped out" of this bull market, and (2) new highs on the Averages (if they are attained) will be accompanied by fewer and fewer profitable opportunities as far as the great mass of issues on the New York and American Exchanges are concerned.

Note: The long-term or 30 week moving average of the D-J Industrials (as of October 24) suffered its second downside penetration since October 1960 (moving average now stands at 700). If the decline is to be of the minor variety (see Letter 157), I would expect volume to begin contracting sharply on any further downside action.

TIME MAKES THE "SYSTEM" The stock market is supposed to be "a place where one makes money." If this is true, then all market study should be directed towards uncovering information through which "the making of money in the stock market" is furthered. Blushingly, this writer must admit that the stock market holds other interest for him aside of that of making money. The history of the market is a fascinating study in psychology, ambition, hope, greed, strategy, success and defeat. Often, however, a seemingly "academic" market study can aid one in the formulation of investment decisions. For this reason, I occasionally examine and discuss a subject which is not connected with current market operations.

A popular fallacy holds that all widely-followed market "systems" actually exert an influence on the market itself. From my own study (and contrary to popular opinion), I have found that when a system stirs up too wide a following, that system is on its way (at least temporarily) to ineffectualness and even oblivion.

It is my further observation that the movements of the market (more than any other phenomenon) actually create the system in vogue. For instance, after World War I business statistics (business failures, industrial production, etc.) became widely available for the first time, and great interest was evinced in these figures as harbingers of things to come in the stock market. Perhaps best known of these indicators was the famous "Colonel Ayers Blast Furnace Index." Supposedly, when the blast furnace rate rose above 60%, stocks were in a selling area, whereas when blast furnace production dropped well below 60%, stocks were "a buy". This method actually worked remarkably well during the 1920's. However, during 1928 and 1929 when furnace operations soared into the "blue yonder", followers of this Index found themselves missing the greatest swing in history. That ended the famous Blast Furnace Index.

During the dull, "whip-sawing" markets of the 1940's, a book called "Successful Investing Formulas" (Tomlinson) created quite a stir. It was held that the Industrial Average would always fluctuate between the 1932 low (41) and the 1929 high (381); consequently, stocks should be bought coldly on a percentage scale, and this system came into great vogue. For instance, when the Dow sold above 180, only 50 % common stock were to be held, when the Dow sold above 220, only 20% common stock were to be held, etc. Obviously, followers of the formula systems found themselves out of the market around 1951, early in the great bull market of the 1950's. Thus, interest in the formula systems expired. The formulas were simply applicable to the '40's, not the '50's.

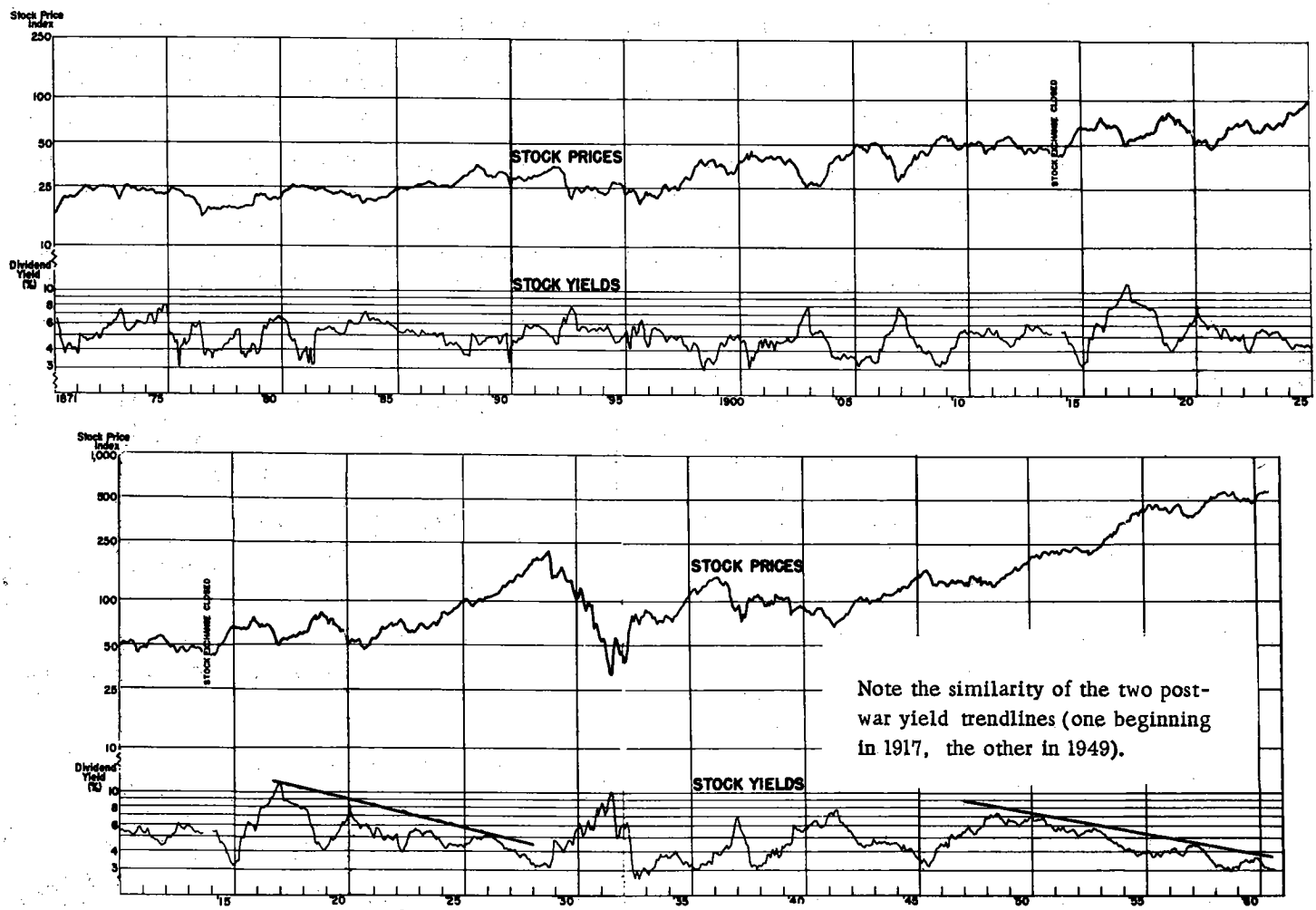
In 1949 Graham's classic book of stock market fundamentals, "The Intelligent Investor", held sway among investors. Fundamentals were in vogue, and "value" was the word on Wall Street. Companies were purchased because they were selling "below book value" or at levels near actual cash holdings per share. Price-earnings of above 10 or 15 were regarded with suspicion. The years 1954 to the present sent fundamentals the way of the horse-and-buggy.

From the period of the late 1950's to the present, "values" could not be used to justify the purchase or retention of common stock. Because of the hopelessness of the classic value approach, the "technical systems" emerged. In the office of one of the leading chart-reading experts in the country hangs a sign which reads: "Don't bother me with facts, my mind is made up." Accumulation and distribution, "insider buying", odd-lots and breadth became the speculative language of the day. This conditon exists at the present. More and more stocks are now being traded on the basis of chart patterns and trend studies, with the fundamentals often being purposely ignored.

Is there a moral in all this? If there is, it is that markets make the system, and when markets change -- systems change. The successful investor is never dogmatic -- he is skeptical of that which is "accepted", and he knows that when a market system is taken as the final truth -- that system is on the way to oblivion. This, of course, explains my periodic discussions of Dow's "old fashioned" concepts of fundamentals such as yields, earnings and values (another "dose" of which appears in the following paragraph).

ARE THEY REALLY HIGH? Last week the partner of a sizable California brokerage house dropped in to see me. "Dick," he said, "My business consists of selling stocks. For years now, people have been telling me that stocks are too high. If I had listened to them, I would have been out of business in 1956. You say that this is strictly a market for traders, and that from the standpoint of the long-term investor, this is no time to 'buy 'em and put 'em away for the kids'. How do you know stocks are really high -- what do you have to go on?"

My answer, I believe, satisfied him, but it did not solve his problem (that of selling stocks). The accompanying chart is



reprinted with the permission of the American Institute of Economic Research, Great Barrington Vt. It shows a remarkable history of stock prices and yields from 1871 to the present. The period from 1871 to 1930 is taken from statistics compiled by the famous Cowles Commission. The period from 1931 to the present is taken from statistics pertaining to Moody's 125 Stock Average.

At the end of July, 1961, common stock yields dropped to an average of 3%. This has occurred only four times in the last 90 years (1899, 1933, 1936 and 1959). Since 1870 common stock yields have decline to the 3.2% or less area exactly 13 times. In each case, stock prices have turned down from such areas within 13 months. Note: a distinction should be made between a rare, low-yield area bottom (such as 1933) and a major low-yield top area (such as 1899 or 1929). In 1933 earnings were necessarily low (although stock prices and the economy were recovering rather rapidly). It is the low yield areas following extended market rises with which we are concerned.

A further interesting comment on yields is provided in the current issue of the Cleveland Trust Company Business Bulletin (I might add that banks and other institutions tend to have a bullish bias). "The average yield on common stocks has declined in 1961 and recently reached its lowest point for this Century," says the Bulletin. They further state: "(1) the average return on stocks has now been below that of bonds for 35 months, the longest in 50 years; and (2) in relation to bond yields, the return on common stocks is the lowest in 50 years."

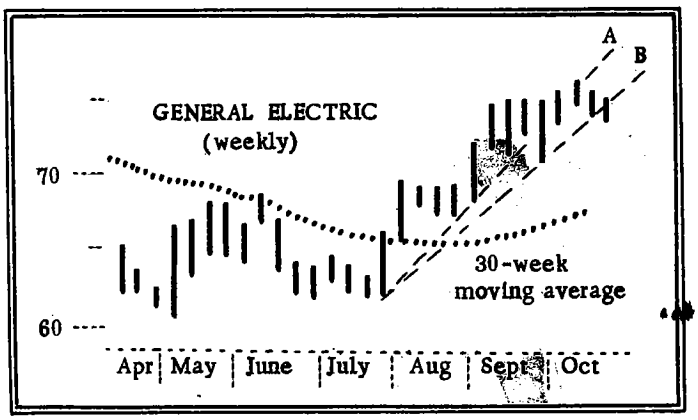
Does this mean that the bull market must end today or this month? Obviously not, but I believe that readers of these Letters (most of whom are sophisticated and intelligent) will not completely ignore this background material as they plan their financial affairs over the months ahead.

STOCKS Seven of the seventeen stocks in our "continuous study" group are now above their long-term or 30 - week moving average. This is a drop of one from last week and puts the total of "key" stocks in a bullish trend below 50%. Stocks which are still in a bullish trend are DuPont, Gen Elect., Gen. Motors, Goodyear, Int. Paper, Sears, and Southern Pacific.

I have been doing an increasing amount of work with moving averages, and starting in the next Letter I will present some interesting information regarding trading techniques which should become increasingly important in this ultra-selective market.

Westinghouse (Letter 158) broke below its rounding bottom on October 24, and is now of interest only because it has lost over 40% of its bull market peak price. Outboard Marine (Letter 155) has broken its potential base, and has now dropped to its lowest level since 1956 (I give up on it). General Electric has broken two trendlines (A and B on chart), and although it is holding well above its 30-week moving average (now 67 1/2), I would be tempted to take my profits. U.S. Steel, faithful to its bearish chart and its extremely poor group relative strength (see Letter 159) has broken all recent support and has been a leader on the downside.

Because of the extreme selectivity of this market, I drew attention in Letter 158 to the relative strength (as compared to the broad Standard & Poor's 500 Stock Average) of various stock groups. The accompanying chart portrays the unfavorable position of the mining and smelting group, as its relative strength plunges to the lowest level in recent years. Obviously, this group should now be avoided. A few groups still show a rising (bullish) trend in relative strength, and these include Business Machines, Golds, Liquors, Rails, Retail Stores, Tobaccos, and Utilities. Stocks in these groups should tend to resist decline and also tend to lead on forthcoming rallies.



Letter 156 drew attention to the strength of the Canadian Gold Average. Not without ominous implications (for the nation) is the great triangle that has now formed in Campbell Red Lake Mines. A rise into the 18 area would constitute a clean "breakout' for Campbell and should be followed by a further extensive move. What such a move would suggest, as far as American's financial position is concerned, is not particularly pleasant to contemplate.

Johns Manville has traced a huge symmetrical triangle. This means that a break either way should be followed by a further extensive move. Short JM on a close of 60 or below; buy it on a close of 68 or better. Based on the poor relative strength of the Building Group, JM is probably going to be a short.

Written Wednesday, October 25, 10 A.M.

Charts of Campbell, Manville and Mining group courtesy of Traders Research, P.O. Box 6185, Lambert Airport, Mo.